

Protecting minority shareholders to boost investment

JEAN MICHEL LOBET

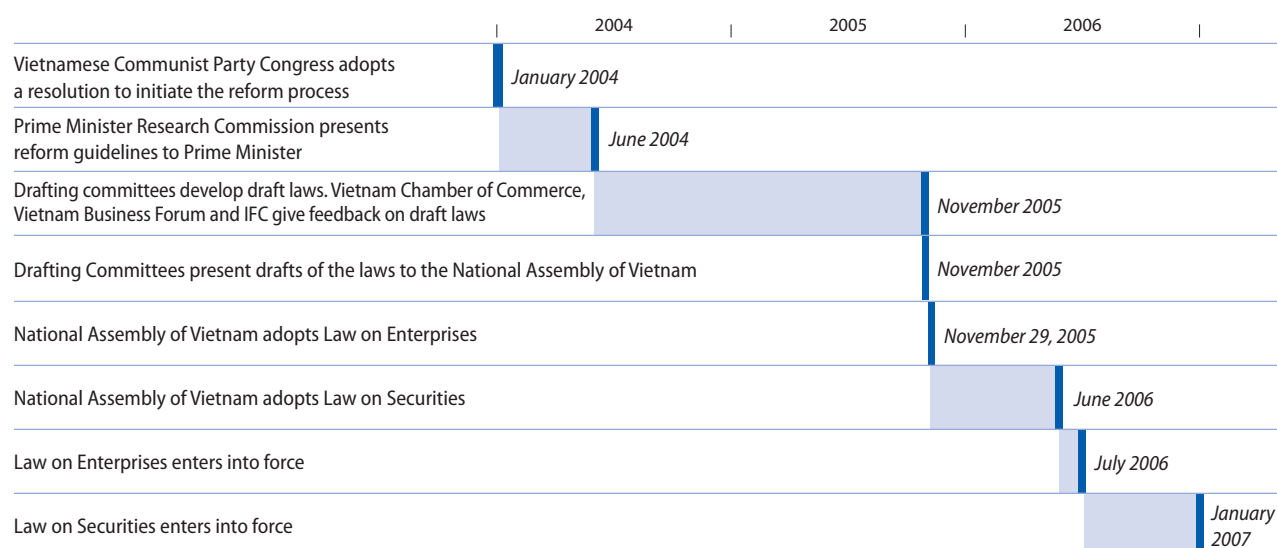
Investors used to be afraid to put their money in Vietnam. Why? Fear that company management would misuse the funds for personal benefit. The previous laws lacked clear rules for transparency and directors' obligations. And the regulatory system governing companies was fragmented and opaque: there was a law for domestic companies (Law on Enterprises 2000), a law for state-owned enterprises (Law on State Owned Enterprises 2003), a law for foreign-owned companies (Law on Foreign Investment 2000), and a law for agricultural companies (Law on Cooperatives 2003).

Vietnam also lacked clear legislation regulating the securities market, with the result that the informal stock exchange was much bigger than the Ho Chi Min Stock Exchange. Several state-owned companies were partially privatized by issuing shares to employees, managers, and the public. They in turn sold them through the Internet and in private deals with family, friends, and acquaintances.¹ An estimated 60–100 trades with VND 15–25 million (\$10,000–16,000) took place every day in the unregulated stock market in 2005. While legal, this gray stock market could not protect investors or ensure orderly, fair, and efficient market mechanisms.

FIGURE 1

Timeline of investors' protection reform in Vietnam

Source: Doing Business database.



These shortcomings spurred reform—a new law on securities and an updated law on enterprises. The reform improved Vietnam’s *Doing Business* protecting investors indicator ranking from 170 to 165 and its overall ease of *Doing Business* ranking from 104 to 91. But implementation remains a challenge.

Building on earlier reforms

The first reform, the Law on Enterprises of 2000, was an important step in developing the country’s private sector. Thanks to that reform, business registrations boomed, creating almost a million jobs.² But the law was weak in regulating such fundamental issues as protecting minority investors. The government knew that the first reform effort was not sufficient and that they needed to go farther in the reform process. “Vietnam needed to show to the world that it was ready to offer higher standards and protections for investors,” says a government official.

Ambitious targets—a spur to reform

To meet the targeted 2006–2010 gross domestic product (GDP) growth rate of 7.5–8% a year, the government recognized that it had to integrate its economy internationally, making unfettered access to world markets a government priority.

Vietnam also needed to create jobs since half of its population was under 40. The government had to accommodate 1.5 million young people entering the work force annually.

Vietnam’s application to join the World Trade Organization was another key driver for legal reform. The accession process required that Vietnam’s laws and legal institutions be transparent, rule-based, and neutral in their application to domestic and foreign business. The gaps in investor protections were large.

Vietnam’s domestic private sector has also repeatedly called for a transparent, predictable, stable business environment with clear laws that do not discriminate on the basis of size or status—domestic or foreign, state or private. A government official explains, “The goals were defined; now, the challenge was to start the reform process.”

Everyone lends a hand

The reform process had to be quick—the deadlines to fulfill the World Trade Organization accession requirements were tight. In about 20 months Vietnam's policymakers developed 2 big pieces of legislation: the Law on Enterprises and the Law on Securities.

The process started in early 2004 after the Communist Party Congress approved a resolution about developing the private sector. To lead the reform process, the government set up the Prime Minister Research Commission—a think tank responsible for designing economic, social, and administrative reforms, the first in Vietnam's history.

The commission presented its first report in June 2004, outlining the reform project to the Prime Minister. Regulatory drafting committees were then established by the Ministry of Planning and Investment. The committees prepared more than 20 drafts before submitting them to the National Assembly.

Many groups—the Chamber of Commerce, international donors, and international law firms—participated in drafting the legislation. “We received high qualified technical support from the private and public sector,” explains a member of the commission.

The Vietnam Chamber of Commerce and Industry was the primary facilitator for business-oriented reforms. Through its website, it invited private and foreign investors to provide feedback on the proposals discussed at the National Assembly, facilitating private sector involvement. During the drafting process the chamber ran conferences that attracted nearly a million participants from the private and public sectors.

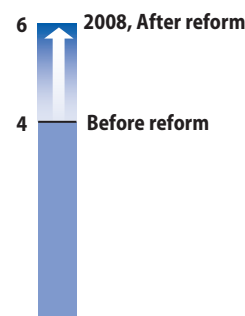
The Vietnam Business Forum—an association founded by international donors in conjunction with the Ministry of Planning and Investment—facilitated dialogue among donors, the private business community, and government leaders. The dialogues gave business representatives privileged, direct access to the Prime Minister and key policymakers before they presented the drafts to the Assembly. The Vietnam Business Forum also published position papers on drafts to commentary and debate.

Many international law firms also provided technical advice to the government. “Their input was fundamental,” explains a reformer, “since they represented two different positions at the same time: first, as practitioners, and second, as representatives of the private sector.”

The donor community, including the U.S. Agency for International Development, the World Bank and the International Finance Corporation, participated in the reform as well. Donors offered technical assistance and assigned several thousand dollars to the reform process—\$100,000 from the International Finance Corporation alone.

On 29 November 2005 the National Assembly adopted the Law on Enterprises, which came into force on 1 July 2006. In June 2006 the National Assembly passed the Law on Securities, which came into force on 1 January 2007.

FIGURE 2
More disclosure after reform
Disclosure index



Source: Doing Business database.

Unified and strong laws on corporate governance

The Law on Enterprises unifies the regulatory system for different corporate structures. A single law now regulates all companies regardless of ownership or corporate form. To protect minority investors against directors' misuse of corporate assets, the law mandates special approval processes and transparency requirements for transactions between interested parties.

The law also increases shareholders' participation in approving important company decisions. Shareholders must approve transactions exceeding 35% of the assets of the company. And directors are required to manage companies more transparently, making publicly available relevant information about important transactions.

For the first time the law introduces director duties—rights and obligations that directors must fulfill during their appointment. But no mechanism for enforcing these duties has yet been adopted. And there is no way to sue directors if they do not fulfill their duties because commercial tribunals lack jurisdiction over these cases.

Shareholders or groups of shareholders holding 10% of the total shares now have the right to review corporate records and financial reports, to request that the board of directors examine management and operational problems, and to convene shareholder meetings if management violates shareholder rights or directors' duties, or makes decisions beyond its power.

When additional ordinary shares are issued, the law also provides pre-emptive rights to ordinary shareholders—the right to maintain their fractional ownership by buying a proportional number of shares of the future issue.

The new Law on Securities promotes transparency in day-to-day management, detailing reporting and disclosure obligations for public companies, listed institutions, securities firms, fund management companies, the Securities Trading Center, and the Securities Exchange. Companies must inform the shareholders and stakeholders of fundamental decisions through mass media, institutional and corporate publications, the State Securities Commission, the Securities Exchange, and the Securities Trading Center.

Finally, the law establishes the Securities Exchange and the Securities Trading Center as the 2 main trading venues. The Securities Exchange is a central securities trading market, and the Securities Trading Center is an over-the-counter market (to counter the gray market) for companies that do not meet Securities Exchange listing requirements.

Overcoming internal opposition

Among provincial governments, big opposition grew to the one-stop process for incorporating a company. The new law radically reduced provincial authorities' involvement—and thus their control.

The reform law also created apprehension in the management of state-owned companies. A key goal was to unify the legislation regulating domestic companies, state-owned companies, and foreign-owned companies. Managers of state-owned companies feared losing their privileged status. And directors of state-owned companies and private companies were reluctant about disclosure, transparency, and liability for mismanagement.

How were these difficulties overcome? First, “Vietnam did not have much of a choice,” says a government official. The reforms were among the several requirements for gaining access to the World Trade Organization and a bilateral trade agreement with the United States. Second, reformers showed that the 2000 reform of the enterprise law prompted a boom in business. In just a few years about 60,000 new businesses had been registered, creating about a million jobs. The government explained that by improving securities regulations and attracting domestic and foreign investment, reform “will help industry create \$10–15 billion by 2010 and turn the securities sector into an important channel for mobilizing capital.”³

More attractive capital markets for investors

The initial impact of the reform is greater confidence, evident in market indicators. Vietnam's stock market in 2005 consisted of only 41 listed firms, with a market capitalization of less than \$1 billion, or 1.2 percent of GDP. Today, 107 firms are listed on the Ho Chi Min Stock Exchange. And Vietnam's primary index (VNINDEX) has trended steadily up.

Foreign direct investment is also up from \$6.2 billion in 2005 to \$10.2 billion in 2006. In the first quarter of 2007 foreign direct investment commitments were 55% above the same period in 2006. And private investment funds increased radically during 2006–07. Finally, today three of the largest investment funds in Vietnam are managing almost 4 billion USD.

The World Trade Organization accession in January 2007, new legislation on foreign investment, and the boom in the real estate market make it difficult to attribute these movements directly to the new enterprise and securities regulations. But it is clear that Vietnam has become more attractive to investors. Vietnam's accession to the World Trade Organization has created a better environment for investment, building confidence that the government will adhere to regulations that respect international standards.

Implementation—delicate

Implementation is the most delicate point of the reform. Private sector representatives believe that the implementing decrees and circulars for some sectors deviate from the law, even though a main objective of the new legislation was to unify the previously fragmented system. Despite the stronger corporate governance and investor protections, implementation and compliance are likely to take time.

The Enterprises Law does not contain sufficient enforcement mechanisms. Commercial tribunals do not have jurisdiction over corporate governance matters. Only a few judges specialize in commercial law; fewer still, in corporate governance. Judges may be influenced by the stronger party. And there is a significant case backlog, as many as 80,000 in Hanoi alone. So, enforcement is time consuming and expensive—and the outcome is uncertain.⁴ Most disputes are still solved informally with negotiation. If minority shareholders cannot negotiate a satisfactory outcome, they are more likely to sell the shares and terminate the relationship than to seek relief in court.

Infrastructure limitations are also a problem: although the Securities Law has significant disclosure and reporting requirements, the systems to store and monitor the information electronically do not yet exist.

Exploiting momentum for change

Vietnam, in a short time, has reformed the 2 pillars of its legal framework regulating the life of companies—and thus the destiny of private sector. The government built on the success of previous business law reforms to promote future reforms—as a reformer explains, “reform success breeds reform success.” Increased legal certainty because of the new securities and enterprises laws will draw more investors and capital to Vietnam.

Notes

1. <http://www.time.com/time/magazine/article/0,9171,1592579,00.html?iid=chix-sphere>
2. UNDP, <http://content.undp.org/go/newsroom/choices-one-million-jobs-created-by-new-enterprise-law-in-viet-nam2003-06.en?categoryID=349425&lang=en>
3. Securities Law: Turning Securities Market into Important Capital Mobilization Channel (http://www.cpv.org.vn/details_e.asp?topic=58&subtopic=156&id=BT2650661466)
4. Clifford Chance VILAF-Hong Duc, Vietnam Investment and Legal Guide (2006)